Billions in Muni Bonds Had Ratings Slashed. Blame Puerto Rico

- Market hit with wave of upgrades, downgrades by S&P this week
- New York, Connecticut bonds cut over change in methodology

By Amanda Albright

(Bloomberg) -- More than $40 billion of bonds sold by New York were stripped of their AAA status this week. Some $3.7 billion in debt issued by Chicago's convention center operator vaulted out of junk. And more than $6 billion of Connecticut debt was slashed two notches.

Nothing about the governments has changed. The only difference was a new yardstick being used by S&P Global Ratings.

The rating company's reevaluation of so-called priority lien debt -- which has a top claim on certain state and local government revenue -- comes amid doubts about whether that legal security would withstand a financial collapse like the one in Puerto Rico, which is in the midst of a record bankruptcy. S&P said the shift pushes the ratings on such securitized debt closer to those of the underlying government, reflecting the risk that officials could try to tap those funds if they experience distress.

Investors and issuers have been put on notice that many ratings are poised to change: S&P, which grades 1,300 different priority-lien tax-revenue obligations, estimates that as much as 45 percent of those ratings could rise or fall two notches or more. Just 15 to 25 percent of ratings are expected to stay the same, it said in a report.

Frances Lewis, a managing director at MacKay Municipal Managers, said it's been tough for the market to digest the changes so far. "Super-downgrades are just very detrimental to the market," she said. "The rating agencies lose credibility."

Puerto Rico used the securitization technique on bonds backed by sales-tax revenue, known as Cofinas. That debt, initially rated A+ in 2007, well above the island's general-obligation rating at the time, was created to provide a well-rated source of financing. Now, Cofina bondholders will likely have to share those funds with general-obligation bondholders as part of a restructuring agreement reached this year, even if owners of some of the highest priority Cofinas stand to recoup almost all of their investment.

Not An Island

Charles Doraine, CEO of Doraine Wealth Management Group, said that outcome casts doubt on the legal claims that stand behind other securitized bonds.

"What happens in Puerto Rico will affect the whole country," said Doraine, whose clients own Puerto Rico sales tax debt. "If anybody can figure out a way to get past the securitized paper and use it to pay off the GOs, then the whole world changes. Securitized no longer means anything and everything reprices."

The structure was used by other financially-strapped issuers, including Chicago and Connecticut, which have driven down their borrowing costs by selling debt that has legal claim on sales-tax funds. That makes them more secure than debt backed only by a promise to repay.

S&P changed its criteria to reflect a shift in how the market views such debt in light of Puerto Rico and other municipal bankruptcies, said Sarah Sullivant, an analyst at the company. "That change hasn't happened overnight, our evolution of thinking also didn't happen overnight," she said.

The New York sales-tax and personal-income tax bonds were downgraded because the revenues backing the bonds "might not receive priority" in cases of distress, S&P said. The rating was cut to AA+ from AAA, making it now in line with New York state's rating.

Rival Fitch Ratings made a similar change to its criteria earlier this year, which also triggered multi-notch downgrades. Moody's Investors Service already discounts the safety of the securities by generally capping the ratings of dedicated-tax bonds at the same level as a government's general-obligation bonds.

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